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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1929.

No. ~~554~~ 23

CHARLES H. STANGE, PETITIONER.

v.

UNITED STATES OF AMERICA, RESPONDENT.

MOTION TO SET ASIDE PART OF LIMITATION OF ORDER AND MEMORANDUM IN SUPPORT THEREOF.

W. W. SPALDING,
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Counsel for Petitioner.

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Of Counsel.

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UNITED STATES OF AMERICA, RESPONDENT.

MOTION.

Petitioner now moves the Court as follows:

That the Court set aside so much of its order of March 3, 1930, as confines counsel to a discussion, in their briefs, of the questions involving the validity and effect of the waiver of the statute of limitations involved in this cause.

Petitioner submits herewith its memorandum in support of this motion.

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MEMORANDUM.

MAY IT PLEASE THE COURT:

The questions raised and decided by the lower Court include not only those arising under the statute of limitations, but also that relating to the original validity of the additional tax collected from petitioner. Was there at any time lawful authority for this imposition? This question goes directly *to the merits* of the enforced claim of the United States against petitioner for additional income tax for 1914.

The claim of the United States rests upon the assumption that petitioner received in 1914 a taxable dividend from the A. H. Stange Company, the Union Land Company, and or the Kinzel Lumber Company in the amount of $642,138.40. In fact, income taxes have been collected from petitioner on the basis of this assumption.

Aside from the questions relating to the statute of limitations, petitioner has at all times contended, (*a*) that the distribution made by the corporations named did not constitute a *taxable dividend* under the Revenue Act of 1913, and (*b*) that, in any event, the taxable element in the distribution should be limited to the earnings or profits of the corporations making the distribution, at the time of distribution. The latter contention, if sustained, would effect a reduction of the taxable income from $642,138.40 to $140,318.27.

In granting the writ of certiorari the Court annexed the limitation that counsel shall confine themselves, in the briefs and in oral argument, to the questions involving the validity and effect of the waiver of the statute of limitations. We respectfully ask for a reconsideration of this limitation as it relates to the briefs to be filed in the cause.

The ground of the application for the writ, so far as the validity of the tax itself was concerned, was that the decision of the lower Court was in "conflict with the decisions of this Court in Mobile & Ohio Railway Company *v.* Tennessee, 153 U. S. 486, and Lynch *v.* Turrish, 247 U. S. 221, and with the implication of the decisions of this Court in the Lynch-Hornby case, 247

U. S. 339, the Phellis case, 257 U. S. 156, and the Rockefeller case, 257 U. S. 176."

The application thus conformed to Paragraph 5 of Rule 35, which lists as one of the grounds for the writ that will be considered by this Court a situation where the lower Court "has decided a Federal question in a way probably in conflict with applicable decisions of this Court." Cf. Paragraph 6 of Rule 38. We respectfully suggest that this provision of the rule is applicable with special force to a case where, as here, the writ has been issued and the decision of the lower tribunal as it relates to two of the questions involved, is to be reviewed by this Court. We take the liberty of submitting these considerations:

1. The question of the inherent right or wrong of the claim involved in any litigation is always a matter of concern to the Court when the right or wrong of the claim has been properly put in issue. Justice reflects the right or wrong of claims advanced by the parties and it is the right or wrong of the Government's claim that is involved in the present litigation. It is most appropriate, we suggest, that this question of inherent right or wrong be decided by this Court.

2. The question of the legal liability to a Federal tax—a liability that implies the exercise of the sovereign power of taxation—is one that is peculiarly within the province of this Court to decide. Only by the exercise of this jurisdiction may the taxpayer be protected from the exercise of assumed but mistaken power on the part of the taxing officials. The limits

of the power of the general government to lay and collect taxes are prescribed by the Constitution. To keep the taxing officials within those limits is, we respectfully suggest, one of the important functions of this Court. If this consideration is applicable to the questions arising under the statute of limitations, it is applicable *a fortiori* to the question of the original validity of the tax.

Coming to the merits of petitioner's contention as to the inherent right or wrong of the claim of the United States, to us it seems almost axiomatic that the taxable element of a dividend is limited to the corporate earnings or profits distributed to the stockholders. So, it was decided by this Court in Mobile & Ohio Railway Company *v.* Tennessee, 153 U. S. 486, and Lynch *v.* Turrish, 247 U. S. 221. Petitioner's position on this subject is also supported by the implication of Lynch *v.* Hornby, 247 U. S. 339, the Phellis case, 257 U. S. 156, and the Rockefeller case, 257 U. S. 176. Indeed, we confidently submit that no decision of this Court can be found which holds to be taxable any corporate distribution which was not made out of corporate earnings or profits.

The decision of the lower Court to be reviewed herein holds that the taxable element in a dividend is not confined to earnings or profits of the distributing corporations. Hence, the conflict with the decisions of this Court.

As shown by the findings of fact of the Court below (Finding XII), the Commissioner of Internal Revenue ruled that the corporate distribution here involved

was in the amount of $4,494,968.81 and that one-seventh thereof (petitioner's proportion of the outstanding stock of the distributing corporation), or $642,138.40, should be taxed to petitioner. The only corporation of the three concerned in the transaction that had any accumulated earnings or profits (earned surplus) at the distribution date was the A. H. Stange Company. Excluding unrealized appreciation of timber lands, its total earned surplus at that time was $982,227.93 (Finding VI). That amount and no more may be regarded as constituting a taxable dividend, if the taxable element is to be limited to the earnings or profits of the distributing corporation. Nevertheless, the Commissioner of Internal Revenue ruled, and the lower Court approved the ruling, that a taxable dividend of $4,494,968.81 resulted from the distribution. Of the earnings or profits actually distributed, petitioner received one-seventh thereof, or $140,318.27, which may be compared with $642,138.40, the amount actually taxed to him.

It does not answer to say that in addition to its earned surplus the distributing corporations also had on hand a large amount of unrealized appreciation of timber lands. Such unrealized appreciation is not *earnings or profits* within the meaning of revenue legislation. As expressly said by this Court in the Lynch-Turrish case, 247 U. S. 221:

> "The timber lands were the property, capital, and capital assets of their legal and equitable owner, and the enhancement of their value during a series of years 'prior to the effective date of an income tax law, although divided or dis-

> tributed by dividend or otherwise subsequent to that date, does not become income, gains, or profits taxable under such an act'."

Nor does it answer to point to the fact that, instead of distributing the appreciated assets in kind, the Union Land Company and the Kinzel Lumber Company issued to the stockholders their debentures based on the appreciated value of such assets. If the assets had been distributed in kind, the taxable element would be limited to the earnings and profits of the distributing corporation; and the material aspects of the case are not altered because obligations of the distributing corporation predicated on the appreciated value of the assets were distributed. In either case, the ultimate question is this: What was the maximum amount of earnings or profits of the distributing corporation transferred to the stockholders, *i. e.*, earnings or profits as those terms are understood in revenue legislation? Any other view might lead to the conclusion that *every* distribution of a corporation to its stockholders constituted a taxable dividend under the Revenue Act of 1913. In construing that Act, however, this Court, in the Phellis case (257 U. S. 156), said:

> "Disregarding the slight looseness of construction, we interpret 'gains, profits and income derived *from* * * * dividends', etc., as meaning not that everything in the form of a dividend must be treated as income, but that income derived *in the way* of dividends shall be taxed."

(The italics appear in the opinion.)

The only difference material here between the Revenue Act of 1913 and subsequent Revenue Acts is in the requirement of the later Acts that corporate distributions, to be taxable, must be made out of earnings or profits accrued subsequent to March 1, 1913. The provision as to the time of accrual is omitted from the Revenue Act of 1913. It is true of that Act, just as it is true of the later Acts, that the taxable element in any such distribution is limited to the corporate earnings or profits passed to the stockholder—in the case of the later Acts, earnings or profits since March 1, 1913; in the case of the earlier Act, earnings or profits of any period, but always earnings or profits.

The Income Tax Amendment to the Constitution permits the taxation of income, not capital; and it has been held by this Court in the Lynch-Turrish case (247 U. S. 221) that a corporate distributon of unrealized appreciation accrued prior to the effective date of the Amendment is not *income* to the recipient stockholder. It is merely a return of a part of his *capital* investment in the stock of the distributing corporation.

Concluding this memorandum, we respectfully request a rereading by the Court of what is said on this subject at pages 14-20 of the brief for petitioner on the application for a writ of certiorari in the present case.

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